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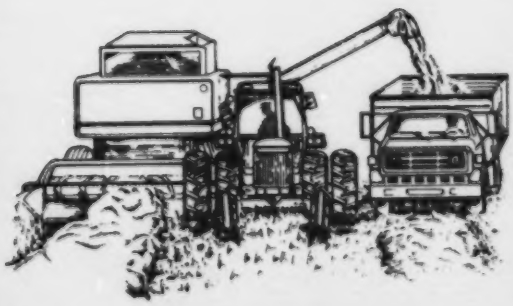

Farm Business Arrangements

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Preface

A farm business arrangement is an agreement between two or more people to combine their resources in a farm operation. This may involve the pooling or sharing of land, machinery, livestock, labor, expenses and income.

Many economic and social factors must be considered when an arrangement is established. This publication outlines these considerations for the following types of arrangements.

1. **Labor Incentive Arrangements**
2. **Machinery Sharing Arrangements**
3. **Equipment Leasing**
4. **Land leasing**
5. **Livestock Sharing Arrangements**
6. **Partnerships**
7. **Joint Ventures**
8. **Corporations**
9. **Co-operatives**

Legal and accounting advice should be obtained when dealing with specific situations or problems.

For further information or additional copies of this bulletin, contact your Agricultural Representative, Regional Farm Management Specialist, or the Farm Management Section, Saskatchewan Agriculture, Room 329, Walter Scott Building, Regina, Saskatchewan.

Farm Management Section
Saskatchewan Agriculture
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1. The Role of Farm Business Arrangements

The family farm is the basic operating unit in Saskatchewan agriculture. However, the size of the family farm unit, its output, and the capital investment have been increasing steadily. As a result, a growing number of individuals, both related and unrelated, are looking at combining their resources to some degree in order to overcome labor problems and high capital requirements. This may be strictly an operating arrangement where each party retains ownership of their respective land base, or a formal business organization with multiple ownership. The opportunity to share labor and management provides for backup in the event of sickness or for periodic leisure time. Shared ownership provides the opportunity to make more efficient use of high cost capital items. Evidence also suggests that optimum efficiencies of scale for the farm business can be achieved with two or three man operations. Thus, the trend is towards utilization of some form of business arrangement.

Selecting a business arrangement requires careful consideration. The way in which a business is organized will often have a considerable bearing on its ultimate success or failure. There are also definite legal and tax implications affecting each arrangement. For every individual situation and size of operation, there is some optimum form of business arrangement which should be employed. The objective, of course, is to ensure that the owner or owners of the business can maximize the personal and financial goals they have set for themselves with a minimum of difficulty.

II. Labor Incentive Arrangements

It is difficult to hire qualified and reliable employees, especially for livestock operations. Many farmers pay higher wages, provide better working conditions, fringe benefits, monetary bonuses and income sharing plans in order to attract and retain skilled individuals.

1) Bonuses

The hiring of seasonal and casual help usually involves a verbal agreement. However, remuneration of full-time employees sometimes includes a share of income or a bonus which is geared to profit or production levels. Under these circumstances, a business agreement should be prepared.

A straight forward labor incentive arrangement can provide that a cash bonus be paid for above average performance. The bonus should be paid in addition to a reasonable wage. The bonus can reflect additional responsibilities and should be based on duties that can be influenced by the employee's performance. Bonuses may be paid on production levels such as milk produced per cow, or pigs weaned per sow. On grain farms, the bonus may have to be tied to careful operation and maintenance of equipment or extra hours worked during peak seasons. There are many types of bonus programs. Following are several examples of those which have been used:

a) a scaled bonus for exceeding agreed lactation production

b) a monthly cash bonus for keeping breeding records up-to-date

c) a scaled bonus for low bacteria counts

d) a cash bonus for each calf weaned in excess of 85% of total cow herd

e) a cash bonus for each piglet weaned in excess of 16 per sow per year.

2) Profit Sharing

An income or profit sharing scheme is more involved. The dairy industry makes use of the following programs:

a) one per cent of the milk cheque, gradually increasing to 5% with continued employment

b) four to eight per cent of returns over all feed costs

c) one to two percent of gross receipts.

An income sharing arrangement is often used in family situations (eg. a son initially joining the operation). For other employees, incentive schemes will be more satisfactory if they are not directly related to product prices, which are not within their control. Problems also arise when dealing with a percentage of profits because of the difficulties in defining actual costs. An incentive payment based on a physical unit of production is more predictable and bears a greater relationship to the employee's job performance.

Although each farming situation is unique, there are broad guidelines which every farmer should contemplate when offering an incentive plan. These are:

a) the incentive plan should be clear to both parties and simple to administer

b) it should be based on some facet of production over which the employee has some control

c) it should not result in the employee wasting inputs in his attempts to increase quantity or improve quality

d) the reward level should be high enough to motivate the employee to do better work, but not so high that the employee is paid more than is reasonable

e) the reward to the employee should be immediate.

Drawing up an incentive scheme which meets the foregoing criteria will take considerable thought and ingenuity by both the employer and employee. Keep in mind that the employee may mistrust an incentive scheme - particularly if he has not been involved in drawing up the plan. An incentive plan can be justified only to the extent that is mutually advantageous and rewarding to both parties.

III. Machinery Sharing Arrangements

Many farmers share individual machines, lines of equipment or all machinery in order to reduce overhead to release limited capital for other uses and to attain better labor utilization. The exchange of labor for machinery is commonly used by beginning farmers. Depending on the number of participants, level of investment, and complexity, these arrangements can be governed by a written agreement, a syndicate, or a co-operative.

1) Sharing Individual Machines

When two farmers share a specific machine, an agreement outlining each party's share and responsibility is sufficient. Investment, depreciation and operating costs should be divided according to the amount of use (i.e. acres, tons, hours). For example, two farmers agree to mutually purchase a stonepicker. Farmer A will use the machine on 400 acres while Farmer B will use it on 600 acres. Farmer A should be responsible for 40% and farmer B for 60% of the original investment. Likewise, all repair costs should be split 40-60 at year end. In the case of motorized equipment such as a self propelled swather, it is advisable that each party be responsible for fuel and lubrication when the machine is used on their own farm.

2) Machinery Labor Exchange

Fathers and sons often enter into machinery sharing arrangements based on an exchange of labour. The son uses the father's machinery and in return provides labour on the father's farm. A straight forward agreement can be established which spells out the son's share of annual machinery costs and a basis for valuing his labour. A cash settlement can be made at the end of the year if one party contributes more than the other. The following example illustrates a procedure that may be followed for machinery-labor exchange arrangements.

A father and son have 700 and 300 cultivated acres, respectively. The father owns all the machinery on which annual investment and depreciation costs have been computed to be $20,000. Each individual provides fuel and lubrication when the machines are used on his land and split the remainder of machine costs on a 70:30 basis. During the year, repair costs were $5,000. In this same year, the son's labor contribution on his father's farm is valued at $6,000. In this case, the father has contributed his own share of the machinery costs plus:

a) the son's share of annual overhead ie. $20,000 x 30% = $6,000

b) the son's share of repair costs ie. $5,000 x 30% = $1,500

The father has made a total machinery contribution of $7,500 versus the son's $6,000 labour contribution. Thus, a payment by the son to the father of $1,500 will balance the arrangement for the year.

3) Rental Charge for Machinery

In a rental arrangement, the farmer with the machinery would charge the farmer without the machinery a rental fee for each machine operation. This rental fee would include ownership and repair costs of the machinery owner. The rental fee could also include a margin for profit and risk. Saskatchewan Agriculture's annual "Farm Machinery Custom and Rental Rates" bulletin may be used as a guideline for determining a rental rate.

A rental structure of this nature could be used for a father/son arrangement. The father would be responsible for paying all the repair costs. The son would be responsible for fuel and lubrication. This arrangement would eliminate the confusion of allocating costs as the son would not be responsible for any of the ownership or repair

costs. If the son works additional hours on the father's farm, then an hourly wage could be paid and this would offset the rental charges for machinery.

4) Custom Charge for Machinery

In this arrangement, the farmer with the machinery would charge the farmer without machinery a custom fee for each machine operation. The custom fee may include an allowance for labor, and a profit margin. Saskatchewan Agriculture's annual 'Farm Machinery Custom and Rental Rates' bulletin could be used as a guideline in establishing rates.

A father-son arrangement could be set up on a custom basis. The father could hire his son and pay him a wage. The son would provide and be paid for labor on his and his father's farm. The father would charge his son a custom charge for each machine operation. The fee would include a labor value. Wages owed to the son would be offset with custom charges for machinery. Any difference between the two values could be equalized by a cash settlement at the end of the year.

5) Syndicates

In situations were two or more farmers wish to share several pieces of equipment, a more intricate type of agreement may be necessary. A formal syndicate may be considered. The agreement should spell out the rules by which the syndicate will operate. The agreement should include the following:

- provision for election or appointment of necessary officers

- assignment of responsibilities to officers for handling records and finances; conducting daily business; repair, maintenance and storage of equipment, etc.

- designation of a bank through which syndicate business will be conducted

- a method of allocating each members' share of investment and collecting their share of capital, operating and other costs

- the amount of work or quota allowed to each member for use of machinery

- the order of use of the machinery by members

- the basis of charges to members for use in excess of agreed quotas

- the arrangements, if any, for rental of or custom work with syndicate machinery and the charges to be made for such work

- the responsibility of a member to the syndicate for accidental damage or negligence to machinery when operated by that member.

Syndicates are most practical where expensive specialized equipment is needed, yet is not seasonally critical. Following are examples of where machinery syndicates have successfully operated:

- a group of vegetable growers purchase equipment to be used for the grading, washing and packaging of their produce

- four medium-sized farmers mutually purchase grain drying equipment

- several farmers in a Northern area purchase specialized land clearing and breaking equipment to be used co-operatively

- three predominantly grain farmers jointly purchase a full line of haying equipment in order to share capital investment and labour

- three producers purchased a high capacity forage harvester and related forage handling equipment.

The share of investment and operating costs should be split according to level of use as measured in acres, hours, or tons of product.

Following is an example of a syndicate where a forage harvester and windrower are mutually owned and silage harvesting operations are carried out jointly by three farmers. Each one contributes additional machinery and manpower to the operation. Based on hours of operation on each farm, members then settle with one another in accordance to their relative contribution.

Capital investment by the syndicate	
1. S.P. Windrower	$16,000
2. Forage harvester	$15,000
Total	$31,000

Contribution Calculation

	Farmer A	Farmer B	Farmer C	Farmer Total
Tons silage harvested/year	400	1,000	600	2,000
%share	20%	50%	30%	100%
Capital contribution	$6,200	$15,500	$9,300	$31,000

Other machinery and labour required in the Forage Harvesting Operation

	Value/hr
1 - 120 H.P. Tractor (Harvesting)	$15.00
1 - 80 H.P. Tractor (Packing)	9.00
2 - 3 T Trucks at $15.00/hr	30.00
5 operators at $8.00/hr	40.00
Total Cost per Hour	$94.00

Contributions supplied by individual members

	Value/hr
Farmer A - 80 H.P. Tractor	$9.00
1 operator	8.00
Total Contributions	$17.00
Farmer B - 120 H.P. Tractor	$15.00
Truck	15.00
2 operators	16.00
Total Contributions	$46.00
Farmer C - Truck	$15.00
2 operators	16.00
Total Contributions	$31.00

Settlement based on 120 hours of total operation:

	Farmer A	Farmer B	Farmer C	Total
Dollar contribution provided by each member	$2,040*	$5,520	$3,720	$11,280
Hours of use/member	26	62	32	120
Cost to each member at $94.00/hr	$2,444**	$5,828	$3,008	$11,280
Difference	-$404	-$308	+$712	$0

* $17.00/hour x 120 hours = $2,040
** $94.00/hour x 26 hours = $2,444

In order to make settlement, Farmer A must pay Farmer C $404 while Farmer B pays Farmer C $308. In this type of arrangement, each member provides the fuel required during operations on his farm. Repairs to syndicate equipment are divided according to hours of use at the end of each year.

The concept in this example involves weighting contributions versus benefits. The actual mechanics of computing a fair settlement can vary. For instance, fuel can be included with a contributed machine and a higher value changed. As well, calculations could incorporate a rental charge for syndicate equipment (based on hours of use). The fees collected can be deposited into a common fund from which repairs and finance charges are paid. The important point is that the computations and dollar values used are clearly understood and agreed to by all members.

6) Co-operatives

Machinery co-operatives may be incorporated under the Co-operative Production Association Act. Any two or more individuals may form a co-operative venture by sending a properly completed Memorandum of Association and a set of Bylaws to the Registrar of Co-operative Production Associations in Regina. The control and responsibility for the co-operative rests equally with all members.

Two types of machinery co-operatives operate in Saskatchewan. These are:

a) Total Farm Operation

In this arrangement all field equipment necessary for the production of crops is owned by the co-op. All labor, operating expenses and grain receipts are pooled in order to achieve an equitable arrangement (ie. use of seeding and harvesting equipment during seasonal periods). Co-operatives of this type will be discussed later under a separate heading as they do not constitute a strict machine-sharing arrangement.

b) Machinery Sharing

A simplified type of machinery co-op is one which is organized strictly for the purchase of specialized equipment. The equipment purchased usually has no particular time period when it must be used and often involves items which are not used often enough to warrant individual ownership. Examples of equipment found in this type of co-op are snowblowers, scrapers, land levellers, stonepickers, clearing and breaking machinery, and cattle handling equipment. A manager is generally appointed who is responsible for keeping books, collecting rental fees and allocating use of machines. Either the manager or another appointed individual is responsible for the repair and maintenance of machines. A common fund is created into which each member makes an initial contribution.

Equipment purchases may be made out of this fund. Member financing can be either on a equal basis or based on the expected use that will be made of machinery (eg. acreage prorating).

Equipment can be rented to members for a custom charge of so much per hour or per acre. All rents are paid into the common fund and all repair costs and financing charges are paid out of this fund. Depreciation costs may be built into the custom rate or charged in relation to the potential use the member will make of the machine. Whichever method is used, it is necessary that all costs are covered. In situations where members exchange labour or equipment other than co-op equipment, the same techniques illustrated under the syndicate example can be employed.

7) Advantages and Disadvantages

Advantages

a) Reduced machinery investment per cultivated acre frees funds to be used for other productive purposes.

b) Cultural practices may be improved through access to a wider variety of specialized equipment.

c) More effective use of labour resources.

d) Benefits of group decision and/or the sharing of knowledge and experience.

e) Beginning farmers with limited capital have access to modern equipment they could not otherwise afford.

Disadvantages

a) Conflicting time requirements for a particular machine by two or more members - especially with seasonal equipment.

b) Joint liability on financed equipment. A member could be burdened with more than his share of the debt if others fail to meet their commitments.

c) A member who is careless or a poor operator will cause excessive wear and breakdowns at the expense of all members.

d) Differing member needs and desires regarding type, model and size of machinery must be reconciled.

These disadvantages should not pose a problem as long as members are able to co-operate with one another and can compromise on differences. It would be wise to avoid involvement with individuals who are poor financial managers or individuals who lack responsibility.

IV. Equipment Leasing Arrangements

1) Equipment Leases

A lease is a medium term contract, generally for a term of three to ten years. Normally, the contract can not be cancelled during the term unless penalties are paid.

A lease may involve a single piece of equipment or several items (eg. a line of farm machinery). The money involved can range from a few thousand dollars and up. Usually, the lessee negotiates the terms and conditions of a lease with a leasing firm. He then negotiates purchase prices with suppliers of his choice and the lessor issues purchase orders in accordance with those negotiations. The more sophisticated leases includes a committed line of lease credit with many assets being purchased from various suppliers. The term of a lease and schedule of payments can be tailored to fit the individual requirements of the lessee.

A lease may be nothing more than a purchase or it may in fact be a true lease. The Canadian Institute

of Chartered Accountants refers to capital leases and operating leases.

a) Operating Lease

An operating lease is one in which the lessor does not transfer substantially all the benefits and risks associated with ownership of property to the lessee. For accounting purposes, payments on a operating lease are treated as an operating expense.

b) Capital Lease

A capital lease is one in which the lessor transfers substantially all the benefits and risks associated with ownership of property to the lessee. In a capital lease the lessee must treat the transaction as a capital purchase.

Revenue Canada, for income tax purposes, does not refer to operating and capital leases as such, but does recognize that certain leases must be treated as a purchase whereby the lessee must split the lease payments between interest and principal payments. The interest may be claimed as an expense. In addition, capital cost allowance may be claimed on the purchase price. The asset is also eligible for the investment tax credit.

In contrast, if the lease is not required to be treated as a purchase, the lessee may claim the lease payments as a direct expense.

2) Tax Considerations

Revenue Canada's Interpretation Bulletin #233 indicates that if any of the following factors exist in a lease contract, the entire transaction is to be considered a purchase (capital lease) at the time the contract is signed: i) the lessee automatically obtains ownership of the property by the end of the lease term.

ii) the lessee is required to purchase the property by the end of the lease or is required to guarantee the lessor that he will receive the full amount specified in an option to purchase in the lease.

iii) the lessee has the right to purchase the property by the end of the lease at a bargain price. If the price established on an option to purchase is substantially less than what the fair market value of the property will probably be at the date that the option can be exercised, this would be treated as a capital lease.

iv) the lessee has the right to purchase the property by the end of the lease term at a price or with terms that no reasonable person would turn down.

An option to purchase may be part of a lease or it can be a separate agreement or even a verbal agreement. Irrespective of the nature of an option to purchase, the factors indicated above apply.

Many equipment leases have a written or verbal option to purchase price which may in fact be less than the probable fair market value of the machine at the date that the option will be exercised. For example, a common option to purchase price at the end of a five year term for a tractor is 20% of original cost (i.e. - based on 20% residual value). Therefore, a $12,000 option price may be offered for a $60,000 tractor. Over the past number of years, good quality farm machinery has tended to retain its value because of inflation. If inflation continues, would it be realistic to assume that a $60,000 tractor today, would have a value of only $12,000 in five years time? It is possible that Revenue Canada will consider the $12,000 option price to be substantially less than the tractor's probable fair market value at the end of five years. The agreement could likely be viewed as a capital lease; that is, the property is considered to be purchased at the date the lease is signed.

If a lease is considered to be an operating lease at the outset, but the lessee eventually acquires ownership of the property, special tax rules apply for any lease negotiated after December 11, 1979.

These rules apply in situations where the fair market value of the property on the date that the option is exercised exceeds the actual purchase price in the option to purchase. This difference is deemed to be capital cost allowance previously claimed with the result that recaptured capital cost allowance may eventually occur on the sale of the property.

The following example illustrates how the tax rules apply:

Assumptions:

i) a tractor with a value of $70,000 at the beginning of the lease, is leased for a five year term with an annual rental of $15,000.

ii) the lessee purchases the tractor at the end of the lease for $20,000.

iii) the lessee (now owner) sells the tractor at a later date for $80,000.

The deemed capital cost of the tractor is the lesser of:

a) the tractor's fair market value at the date that the option is exercised (eg. - $75,000), or

b) the sum of the option price ($20,000) and the total rent previously paid (5 years x $15,000 = $75,000). This totals $95,000.

Thus, the deemed capital cost of the tractor would be $75,000. The undepreciated capital cost (book value) is deemed to be $20,000 which is the option price. This results in recaptured capital cost allowance of $55,000 when the tractor is sold for $80,000. In addition, there is a $5,000 capital gain. (Beginning in 1985, the Capital Gain Exemption may apply.)

Summary of income tax effect:

a) Effect on capital cost allowance.	
Deemed capital cost	$75,000
Deemed undepreciated capital cost (option price)	20,000
Capital cost allowance deemed to have been claimed	$55,000
b) Effect on capital gain.	
Proceeds of disposition	$80,000
Less deemed capital cost	75,000
Capital gain	$ 5,000
Taxable capital gain (Capital Gain Exemption may apply)	$ 2,500

For operating leases entered into prior to December 11, 1979, the tax treatment when such an option is exercised is more favourable. The capital cost is the option price and any subsequent sale of the asset for an amount in excess of the option price is a capital gain (not recaptured capital cost allowance).

In the above example, under the old rules, the adjusted cost base of the tractor when the option is exercised would be $20,000. When the tractor was sold for $80,000, a capital gain of $60,000 ($80,000-$20,000) would occur. The taxable capital gain is one-half of the capital gain or $30,000. (This amount may be eligible for the Capital Gain Exemption, beginning in 1985.)

3) Cost Considerations

The main factor that farm managers must consider when comparing a leasing arrangement to ownership is the relative cost. In most cases, the alternative to leasing is financing, therefore, the cost of borrowing must be compared to the cost of leasing. It is not possible to offer a detailed explanation of how to calculate these costs within this publication. The approach which is used involves comparing the after tax values of cash outflows on a present value basis.

However, factors to consider are:

a) the opportunity cost of equity capital

b) the after-tax cost of credit (ie. interest) and other loan costs (ie. legal and administrative fees)

c) tax savings associated with ownership such as investment tax credit and capital cost allowance

d) the individual's marginal tax bracket

e) the after-tax cost of rentals to be paid

f) the value of an option to purchase at the end of the lease term, if applicable.

There are no clear-cut cost advantages to leasing versus ownership. It will vary according to each individual situation. In some instances, leasing may be the cheapest method of raising capital. For example, a potential lessee may not be paying taxes due to high operating costs, interest charges and capital cost allowance already available to him. The lessor, on the other hand, may be able to generate substantial tax savings through the benefits of ownership. If the lessor can take immediate advantage of these tax savings, he may be prepared to offer attractive rates to the lessee. These rates could be less expensive than the lessee's cost of borrowing. Conversely, individuals who are in a high tax bracket and/or can attract cheap credit, may find that the potential tax benefits of ownership make leasing unattractive.

4) Advantages and Disadvantages

In addition to possible cost advantages, a farm manager should consider the following advantages and disadvantages associated with equipment leasing.

Advantages

a) Capital Conservation

Leasing is a means of obtaining close to 100% financing. If a farmer does not have a trade-in when purchasing new equipment, his margin of equity must come out of working capital. Where cash flow is restricted or working capital is tight, it may be advantageous to lease.

b) Credit Preservation

Borrowing limits are based not only on repayment

capacity but also on balance sheet ratios. If a wide debt/equity ratio restricts credit from conventional sources, then leasing may be an alternative.

c) Simplified Budgeting and Accounting

Planning and budgeting is simplified by leasing. Because documentation is straight forward, commitments from leasing companies can often be obtained quicker than from lenders. Accounting is also simplified if it is a "true lease" and payments are totally written off as an operating expense.

Disadvantages

a) Less Gain in Equity

During inflationary periods, used equipment has retained its value or in some cases has increased in value. Depending on whether an option to purchase is exercised, equity in equipment may not be built up under leasing arrangements.

b) Restricted Availability of Equipment

The demand relative to supply will affect the availability of equipment for operating leases. During buoyant times, good equipment may not be available for short term leasing since dealer inventories are generally tight. However, shortages will not affect long term leasing (financial leases) any more than would direct purchases.

c) Restricted Flexibility

Financial leases are generally long term with non-cancellable features. If they are cancelled, a penalty is charged which effectively increases the cost of leasing for a partial term. Where a business is undergoing rapid changes in cropping patterns or land base, the resulting cost of long term leasing could prove to be higher than owning and trading equipment.

The above comments provide a general overview of leasing machinery. A more detailed publication entitled "Leasing Farm Machinery" is available from Agricultural Representatives or the Farm Management Section, Saskatchewan Agriculture, Regina.

V. Land Leasing Arrangements

As the capital investment required in farming continues to grow, renting additional land provides an attractive alternative to ownership. Statistics indicate that nearly one-half of Saskatchewan farmers lease a portion of their farmland and that 30% of the province's agricultural acreage is under lease.

Following are the advantages and disadvantages of leasing land:

1) Advantages

a) Obtaining Capital

Since leasing offers an access to additional land, it is really a means of obtaining a larger capital base. Since capital investment is shared between two individuals, an operator can reach a larger size of business. The landlord supplies land, buildings, and perhaps some of the operating expenses. The tenant supplies labor, machinery, and the major portion of the expenses.

b) Increasing Efficiency

When funds are limited it is often more profitable to spend this money on seed, fertilizer, chemicals, and machinery. Investing scarce funds in land may severely restrict the money available for operating capital thus lowering the efficiency of the farm business.

c) Obtaining Farm Experience

Renting enables the beginning farmer to gain needed experience in the financial operations of a farm business before he commits himself to a long-term investment in land. It also enables the operator to learn more about land in an area and leaves him in a more flexible position to change farms or to leave farming. Renting may enable a younger man to obtain the managerial assistance of an older experienced landlord.

d) Sharing Risk

By renting, both the landlord and the tenant can share the risks and uncertainties of farming. This is particularly important to a farmer with limited capital. The extent of the risk-sharing depends upon the nature of the lease agreement.

e) Father-Son Arrangements

A father-son business arrangement might include a lease agreement whereby the son rents land from the father or rents land from a third party and shares the machinery investment with the father.

f) Providing Retirement Income

A retiring farmer might consider leasing all or a portion of his land base rather than selling. The ownership of land provides a hedge against inflation since land values tend to increase with inflation and rising grain prices. The income from

the rent provides a form of "pension" income to live on during retirement.

2) Disadvantages

a) Lack of Security of Tenure

Short term leases create additional uncertainty and insecurity for the tenant since machinery size and complement must be matched to the land base. The cancellation of a lease could leave the tenant farmer in a vulnerable financial position due to debt commitments on large machinery.

Short term leases provide more flexibility for landlords since it is possible to change tenants quickly or to sell the land. However, short term leases can work to the detriment of the landlord since it will not encourage superior farming practices by the tenant.

b) Lack of Efficiency

Short term leases may discourage production efficiency. For example, some tenants will not use the optimum amount of fertilizer under a crop share lease unless the landlord shares the expense of fertilizer.

Most soil conservation practices are of a long run nature. Most tenants with a short term lease are therefore interested only in practices which will show results during the term of the lease. Similarly, improvements of an intermediate or long-run nature (eg. drainage, tree planting, buildings) are not encouraged unless there are provisions for compensation in the agreement.

c) Restricted Credit

A tenant farmer should not have any great difficulty in obtaining short term and operating credit. However, unless there is other land which is owned, long term credit will be difficult to obtain. Should cash flow difficulties be encountered, the tenant farmer will be subject to financial pressure with few alternatives. The owner operator, on the other hand, may be able to restructure current liabilities over a long term using his land as security.

d) Restricted Managerial Control

There may be situations where the landlord makes the most important decisions, even though he is a minority contributor to the arrangement. For example, the landlord may insist on a certain rotation or crop to be grown, which may not be the most profitable from the tenant's viewpoint.

e) Lost Opportunity for Capital Gain

Land prices generally increase over time. Land appreciation is an added benefit to the landowner even though the capital gain is not realized until the property is sold.

3) Types of Land Leasing Arrangements

There are three prevailing types of land leasing arrangements found in Saskatchewan. These are the Crop Share, the Cash Rent and the Flexible Cash Rent. We will briefly discuss each type in order to outline their differences.

a) Crop Share

The crop share lease is the predominant method of leasing crop land in Saskatchewan. In most crop share leases, the landlord receives a one-third share of all crops grown on the leased land and the tenant receives a two-thirds share. The landlord pays the property taxes and supplies grain storage while the tenant supplies all the machinery, labor and crop inputs.

With advanced technology, many variations to the standard crop share lease have occurred. Often, the landlord and tenant will share some costs such as fertilizer and chemicals in the same proportion that the crop is shared. Also, in cases where the land is of superior productivity and has a high market value, landlords may receive greater than a one-third share.

The advantage of a crop share lease is that both the landlord and tenant share the risks associated with changes in grain prices, quotas and yields. The rent varies directly with the value of production and is paid as the crop is sold, rather than in advance. In this manner, a portion of the risk is shifted to the landlord. It has been suggested that a landlord will make more money in the long run on a crop share arrangement compared to other arrangements providing that the tenant is a good manager.

A disadvantage of crop-share leasing is that the results of a tenant's superior farming practices must be shared with the landlord. However, if the tenant is a poor manager, the landlord will make less money on a crop share arrangement. Due to the storage of crop inventory and deferred marketing, there are more administration problems on a crop share arrangement than other rental arrangements.

b) Cash Lease

In a cash lease, the tenant pays a fixed cash payment to the landlord for the use of the land and improvements. He supplies labor, machinery and pays all operating expenses except for property taxes. In return he receives all the crop income. A cash lease is especially suited to absentee landlords or landlords who wish to be

assured of stable income without much administration.

Advantages of cash lease are that the tenant has more flexibility and independence in production and management decisions. Benefits of superior production accrue entirely to the tenant. On the other hand, the landlord receives a guaranteed return and does not have to be concerned with crop yields, grain prices, marketing problems and administration. Because he accepts less risk, the rent should normally be lower than a crop share lease.

The biggest disadvantage of cash rent is that the tenant assumes all risks associated with production and marketing. In addition, rent is paid in advance of crop sales. These two factors place the beginning farmer in an extremely vulnerable cash flow position. During times of restricted marketing situations, working capital requirements become very high.

c) Flexible Cash Lease

Flexible cash leases combine several features of both the cash and crop-share lease. In a flexible cash lease, the rent can vary with either the price of grain or the yield of crops, or both. Since flexibility in rental rates is most desirable when sharp swings in grain prices occur, flexible cash lease arrangements in which the rental rate adjusts with the price of grain are the most popular. The cash rent is usually determined by multiplying an agreed upon quantity of grain by the prevailing price of that grain. The price could be based on an open market street price or on the Canadian Wheat Board initial, interim and final payment for the type of grain stipulated in the lease. For example, the cash rent for a quarter might be based on 800 bushels of 2 C.W. red spring wheat based on the Canadian Wheat Board final realized price for that crop year.

The big advantage of flexible cash leases is that the tenant retains independence and captures the benefits of superior management. At the same time, any risk of change in grain prices is shared by the landlord. Although working capital requirements are still high, they can be eased somewhat if the rent is payable in relation to Canadian Wheat board payments (ie. staggered over an 18 month period). From the landlord's point of view, rent is guaranteed in relation to production but not the price of grain. Although there is more administration than in a fixed cash lease, it is much less than with a crop share lease.

The above comments offer a very general overview of land leasing arrangements. A more detailed publication on the subject titled "Land Rental Arrangements" is available through Agricultural Representative offices or from the Farm Management Section, Saskatchewan Agriculture, Regina.

VI. Custom Farming Arrangements

1) Alternative to Leasing

Frequently, a landlord wishes to remain classified as a farmer and retain close control of the farming business but not be actively involved in its operation. A custom farming agreement may accomplish this objective.

A farmer, but not a landlord, is able to make contributions to the Western Grain Stabilization Plan and to the Canada Pension Plan on earnings from the farm business.

The custom operator in a custom farming agreement does not have the same rights as a tenant in a land leasing agreement. A custom farming agreement is not an interest in land. Consequently, a caveat can not be placed against the owner's title to protect the custom operator's interest, or to warn third parties of its existence. If the owner sold the land covered by the custom farming agreement to a third party who was unaware of it, the custom operator would have to sue the original owner for contractual damages and would have no right to continue farming the land.

2) Preservation of Capital Gain Rollover Provisions and Capital Gains Exemption

Land may be rolled over on a tax deferred basis when it is transferred from a parent to a child, providing the child is a resident of Canada and the land is "used in the business of farming" by the parent, his spouse or any of his children immediately prior to the transfer. Land which is leased to anyone other than a spouse, child, or family farm corporation or farming partnership would not qualify for a rollover.

Further, to be eligible for the immediate $500,000 Capital Gains Exemption on farm land, the land must be "qualified farm property".

Qualified farm property includes:

a) farm land or farm buildings of an individual whereby the property is presently used in the business of farming by the individual, his spouse or a child.

b) shares in a family farm corporation or an interest in a farming partnership providing that the individual, his spouse or a child is presently engaged in the farming business carried on by the corporation or partnership.

c) qualified farm property, which was used in the business of farming for at least five years after 1971 by the individual, his spouse or a child.

All other investments including non-qualified farm properties are eligible for a $100,000 Capital Gains Exemption in 1988 and subsequent years.

The 500,000 Capital Gains Exemption on farmland will be reduced by the exemption used under the provisions of the $100,000 Capital Gains Exemption for other investments.

Individuals who own farm land with accrued capital gains which exceed the capital gains exemption or have property which is not qualified farm property should consider a custom farming arrangement rather than a lease on their land.

For a rollover of capital gain to occur on a property exchange, the land must be "used in the business of farming" by the owner. Land leased to anyone would prevent a property exchange rollover from occurring.

In a properly structured custom farming agreement, the land will be considered to be used in the "business of farming" as opposed to being a rental property as in a lease agreement. Revenue Canada's Interpretation Bulletin #349R, "Transfer of farm property to child on death" indicates that a farm owner may engage the services of another person to undertake virtually all of the work associated with his farming activities (custom working). However, the owner of the farm property should assume some risk and provide some management for the operation.

To be at risk, the farm owner should pay some of the operating costs and stand to loose money if there was a poor crop. His management should take the form of decision making responsibilities for such functions as determining crops and varieties to be grown, fields to be seeded and fallowed, timing of field operations, inputs to be used and dates of crop sales.

In using custom farming agreements, it is important that the actual relationship that exists between the landowner and the custom operator conforms to the agreement. Revenue Canada will look at the actual facts of the situation not the agreement if there are discrepancies between an agreement and the facts of the situation.

Landowners should consider documenting their decision making responsibilities by way of copies of letters of instruction or minutes of meetings.

3) Types of Custom Farming Agreements

There are many variations to custom farming agreements. However, three general categories of arrangements are outlined here. These are:

a) Custom Hiring Agreement

The landowner (farmer) makes all the farming decisions, arranges for and pays for the purchase of all inputs and receives all the income from grain sales. The landowner and the custom operator agree to have one or more custom operators perform the machine operations. The landowner agrees to pay a custom fee to the custom operator upon the completion of each machine operation.

A variation of the above is for the landowner to pay the custom operator a basic lump sum fee by a certain date say, July 31, of each year plus a bonus after the final accounting is completed for the year. The bonus could be a percentage, say 50%, of "net income". "Net income" would be the value of all crop sales attributed to the year minus the costs for custom work, seed, fertilizer, chemicals and property taxes. The bonus percentage amount should depend on the size of the basic lump sum fee in relation to custom rates in the area.

b) Joint Farming Venture Agreement

In this agreement, both parties are considered to be farmers. The landowner supplies land to the joint venture and the other party supplies machinery, machinery operating costs and labor.

The two parties then share the crop sales on a percentage basis, and also share the input costs (seed, fertilizer, chemicals, crop insurance and property taxes) on the same basis.

c) Farming Partnership Agreement

The agreement is much the same as in the joint venture, except that a partnership is established with more defined rules to govern the relationship.

Some custom farm agreements have been drafted in a manner that gives the same financial results and exposure to risk as a crop share lease. A common agreement is one where the landowner (the "farmer") takes out the Canadian Wheat Board permit book in his name. All the crop is sold in the "farmer's" name. After each grain sale or Canadian Wheat Board payment is received, the "farmer" pays cash equal to, say, two thirds of the income received to the custom operator. The custom operator supplies seed, fertilizer, chemicals, machinery, labour and machinery operating costs. It is quite evident that it is the same as a crop share lease. Revenue Canada is very likely to look at these agreements as leases. Therefore, the landowner would not qualify for a capital gain rollover to his child or a rollover on a property exchange or the full immediate capital gains exemption.

Consult a lawyer, accountant or farm management specialist before entering into any custom farming agreement since some agreements may not meet the "used in the business of farming" criteria. Review custom farming agreements that were entered into several years ago to determine if they are in tune with current requirements.

VII. Livestock Sharing Arrangements

Livestock sharing arrangements most often include beef cows although it can also apply to dairy cows or sows. Since arrangements involving dairy cows or sows are not common in Saskatchewan, this discussion is confined to beef cow sharing arrangements.

1) Cow-Calf Arrangements

The calf crop is normally shared in beef cow arrangements. Before entering into such an arrangement, it is important to consider the fairness of the income-sharing ratio, the management ability of the lessee and the adequacy of the terms that are to govern the arrangement. Unless the lease provides sufficient flexibility to keep both parties satisfied, it is not likely to work. Often, it would be more advantageous for the lessee to purchase his own breeding herd, even if financing is required.

In most situations, a cattle owner will lease cows to a farmer with excess pasture, feed or facilities. The share of calf crop can be calculated based on the contribution of each party. The contributions include the fair market value of feed, pasture, investment cost of cows, facilities, labor and cash inputs. The lease agreement may include a formula to determine the share ratio. The agreement should also include the following points:

- an inventory of the herd indicating age, weight and identification of each cow

- a procedure for dividing and marketing calves

- dates to be used for breeding and weaning

- procedures for sharing herd insurance and veterinary expenses

- responsibility for production decisions such as feeding program, dehorning, castrating, etc.

In addition, the procedure for culling and replacing cows must be covered. One alternative is to raise replacements from natural increase. With this method, the lessee shares in the sale value of cull cows in the same proportion as the calf crop is shared. However, it also results in the lessee absorbing the total cost of raising replacements. A more equitable approach is to have the owner responsible for replacement and for him to receive the total proceeds from cull cows.

Death losses in the cow herd also require special consideration. Most often, losses are replaced from natural increases and the lessee is responsible for raising the animals. This again places the major cost of replacement on the lessee. A modification to this approach could be to have both parties share the cost of raising the replacement from weaning to breeding age.

The following example illustrates the use of the contributions approach to calculate a fair income-sharing ratio in cow-calf arrangements:

Assume the owner supplies a breeding herd, replaces breeding stock, receives full sales value of cull cows, and recovers his herd when the arrangement is terminated. Cows are valued at $800 each when placed in the breeding herd and have a $550 salvage value when culled. The renter provides all feed, pasture, housing, labour, veterinary and medicine, a bull and other general services required for maintaining a cow-calf operation. Cow death losses are replaced by purchasing a bred cow and with each party sharing the cost in the same ratio as the calf crop is shared. The calf crop is to be shared in proportion to each party's cost contributions.

Owner's Cost per Cow per Year

Investment Cost $\frac{\$800 + 550}{2} \times 12\% =$	$ 81
Replacement Cost of Cull $\frac{\$800 - 550}{5 \text{ years}} =$	50
Management Allowance	10
Owner's Total cost	$141

Lessee's Cost per Cow per Year

Winter Feed	$115
Bedding	15
Salt, Minerals, Vitamins	12
Veterinary and Medicine	25
Pasture	40
Breeding Fees	20
Machinery Costs	55
Building and Facilities	15
Operating interest	15
Labor and Management	75
Lessee's total cost	$387

Total Cost Contributions = $141 + $387 = $528

Owner's share = $\frac{141}{528} \times 100\% = 27\%$

Lessee's share = $\frac{387}{528} \times 100\% = 73\%$

The preceding example shows that approximately a 1/4 to 3/4 share ratio (owner and lessee respectively) is reasonable for this type of arrangement. Any modification to the above arrangement or shifts in costs may result in a different share ratio. The example merely intends to illustrate the concept used in a contribution approach. In practice, it is imperative that each party fully understand and mutually agree to all aspects of the lease arrangement.

2) Custom Feeding Arrangements

Although the custom feeding of cattle is not a sharing arrangement, it does fall within the scope of a farm business arrangement. Many cow-calf producers have neither the feed base nor the facilities to maintain calves to finished weights.

However, there may occasionally be an advantage to feeding calves out in an effort to overcome depressed prices or gain the benefits of better genetic performance. The custom feedlot allows a producer to carry out this alternative.

Three types of feeding arrangements have prevailed during the past:

- feed cost and yardage contracts

- fixed price per pound of gain contracts

- market price per pound of gain contracts.

The latter two types of arrangements have pretty will disappeared, due to the enormous risk carried by the feeder because of fluctuations in feed grain and market cattle prices. Many feedlots utilizing these arrangements experienced severe financial losses in the early 1970's when feed grain prices rose sharply and the cattle market collapsed. A great number were eventually forced out of business.

As a result, the custom feeding industry in Western Canada is now almost exclusively based on a yardage plus cost of feed arrangement. In this manner, the owner of the cattle carries all the financial risk. The feeder provides yardage, labour and general management service for a flat fee per head per day and sells feed at cost, plus a per ton margin for grinding, mixing, and feeding. The owner of the cattle carries death loss, veterinary, and medical charges, marketing charges and the risk of fluctuating market and feed grain prices. Yardage and processing charges can vary widely depending on the pricing policy of the feedlot. One reason for the variation in feed processing charges is that inputs are not always priced at cost. If the feeder marks up barley, roughage and supplements, he will work on a lower feed processing margin. Also, silage rations cost less to prepare than grain and hay rations, but more pounds of feed are required per pound of gain.

This type of arrangement adds a great deal of financial stability to the feedlot business. Management objectives are then oriented towards efficient feed conversions, a sound health program and controlling overhead costs. By keeping customers satisfied, the feeder can maintain a high level of placements and hopefully realize an adequate return on investment. Any sharp disruptions in the market place will be absorbed by the numerous owners of the cattle. Custom feeding arrangements allow for economies of scale and specialized management while spreading the financial risks over a great number of individuals.

VIII. Joint Ventures

1) Nature of a Joint Venture

A joint venture is another type of farm business arrangement where a farming activity is carried out by two or more parties. The parties involved contribute assets to the joint venture but retain individual ownership of these assets and they jointly operate the business. Joint ventures have a specific term indicating how long the business relationship will last.

Joint ventures are a very common form of business arrangement particularly in father and son business arrangements. They are often referred to as "working arrangements" or "operating arrangements".

As indicated in the section on partnerships, joint ventures can be very similar in nature to an operating partnership especially if grain and livestock income and operating expenses are pooled.

A joint venture is distinguished from a partnership by the following factors:

1. The parties in a joint venture retain individual ownership of assets (land, buildings, machinery, livestock) but contribute the use of the assets to the joint venture. A few assets may be purchased by the joint venture after it begins operations, but the number of assets owned this way will be limited.

2. Liabilities on assets owned individually are a responsibility of the individual parties. If an operating loan or line of credit is required, then either the joint venture can borrow the funds or the individual parties can borrow their required share and reloan that amount to the joint venture.

3. A joint venture will have a specific term to its existence (eg. one year, five years or when something specified is accomplished). A partnership will often have an undefined term.

Joint ventures can be used for a complete farming operation where the income from all the parties assets are pooled, part of a farming operation such as an enterprise (eg. hogs) or for a specific asset (eg. sharing a combine).

Some land owners enter into joint ventures rather than lease their land in order to obtain some specific income tax benefits (rollovers to children and property exchange). These considerations are discussed in more detail in the section on "Custom Farming Arrangements".

2) The Contribution Approach

Parties involved in a joint venture must decide on how income, expenses or net returns will be divided. Since the parties may contribute labor, management and capital to the joint venture, it is reasonable to divide the income or expenses based on the relative contributions of each party. The difficult part is placing dollar values on the contributions.

The "contribution approach" provides a framework for valuing the contributions of each party. The underlying principal is that returns are to be shared in the same proportion as the costs are contributed. The four costs of production are cash operating expenses, interest on investment, depreciation and labor and management.

The following example illustrates a joint venture between a father and son. The operation is based on a grain and beef cow farm. Each party contributes the use of his assets to the joint venture but retains title to them. Only income and expenses of the combined operation are pooled.

While a sharing ratio other than that calculated by the contributions approach may be used, the calculations do provide a reasonable basis for arriving at a share ratio. The individuals in the above example would share both the cash operating expenses and income on the basis of their agreed to percentage split.

Note that the contributions calculations did not include a contributions of cash operating costs since these costs are to be shared proportionately. However, if some or all of the cash operating costs were paid by the individuals and were not shared, then estimates of such costs should be included as a contribution.

Joint ventures can also be used for individual enterprises such as a hog operation, feedlot, cow-calf operation,etc, in addition to the whole farm. When setting up a joint venture, one of the following procedures should be used to divide income and/or expenses.

a) Where the sharing ratio is based on the contrbution of fixed costs (depreciation and investment cost) and labor and management, gross income and operating expenses or are shared in the agreed to ratio,

b) Where the sharing ratio is based on the contribution of all costs (including operating expenses), gross income only is shared in the agreed to ratio. Each party is then responsible individually for the specific fixed costs and operating expenses.

Farm Assets Contributed	**Father**	**Son**
Land (market value)	$740,000	$310,000
Buildings and Improvements (market value)	60,000	5,000
Machinery and Equipment (market value)	150,000	30,000
Breeding Stock (market value)	20,000	5,000
Total Assets	$970,000	$350,000
Annual Cost Contributions	Father	Son
Investment cost - land at 5%	$37,000	$15,500
- other assets at 12%	27,600	4,800
Depreciation - buildings at 5%	3,000	250
- machinery at 10%	15,000	3,000
Labor and management	20,000	20,000
Totals	$102,600	$43,550
Total Contributions (father & son)	$146,150	

Father's $\frac{\$102,600}{\$146,150} \times 100\% = 70\%$; Son's $\frac{\$43,500}{\$146,150} \times 100\% = 30\%$

In calculating the contributions of each party, it is important to use realistic estimates of value. Market values should be used in valuing assets. Depreciation rates should reflect the added cost of replacing buildings and machinery over time. Labor and management should be valued at what each party could earn elsewhere or what it would cost to hire the services each party provides to the farm. The interest on investment should be approximately the same as long-term interest rates. However, in the case of land it is appropriate that a lower interest rate be used since land normally has two types of earnings. These are:

1. an annual interest return on investment (rent);

2. long-term appreciation in value (capital gain).

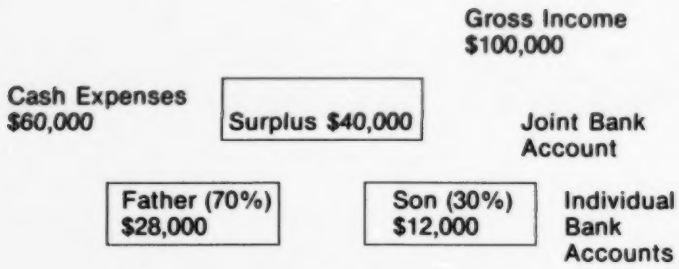
The rental and capital gains earnings are combined to give the total return on land investment. For this reason, a five percent interest on investment allowance has been used in the example, since a reasonable total return to investment may be 8-12 percent.

The share ratio should be reviewed whenever there is a change in the relative contributions of capital and labor or management by any of the parties. Normally, it is better to make a change in the sharing ratio at the beginning of the year, rather than during year.

3) Operating Procedures

The day to day handling of income and expenses for a joint venture is made simpler by establishing a joint bank account for the income and expenses of the joint venture and separate individual bank accounts for the individuals. See Example A below.

Example A

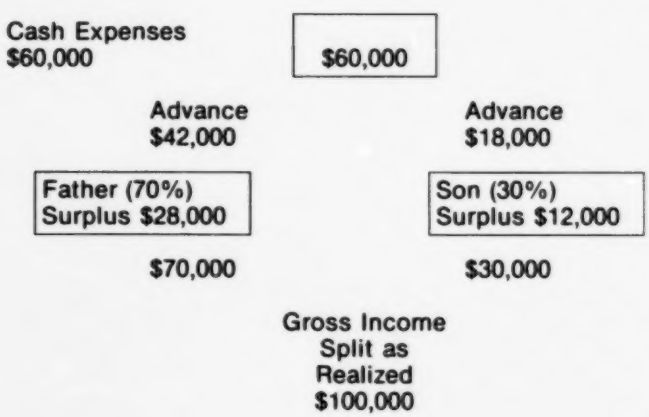


In the above example, all income and expenses are handled through the joint venture's joint bank account. The annual gross income was $100,000 and cash expenses were $60,000, leaving a surplus of $40,000. The father would be entitled to 70% of the surplus or $28,000 and the son would be entitled to 30% of the $40,000 surplus or $12,000. Each individual's share of the surplus could be taken out periodically during the year as drawings. Each time a draw was taken it would be an advance toward each individual's share of the surplus as determined at the end of the year.

Even though the parties may refer to the drawings as a salary or wage, it must always be considered as a draw.

Individuals pay for personal expenses, debt servicing and capital purchases from their separate bank accounts.
Another alternative for handling income and expenses, is to divide the income between the parties as each amount is realized and deposit it directly to each individual's separate bank account. A joint bank account is set up to pay cash expenses. Each party would advance money to the joint account on an agreed to ratio to meet the expenses as they become due. See Example B below.

Example B



On occasion some parties desire a 50:50 income and expense sharing arrangement but their land holdings are not equal. A 50:50 share arrangement would be fair if each party has an equal investment in machinery, provided an equal amount of labor and management, and by having the joint venture pay a "rent" for each party's land, the difference in land holdings can be compensated for.

Capital assets should be purchased by the individuals with their own financial resources rather than having the joint venture purchase the assets. This is certainly the case with land. It may be acceptable to purchase the odd machine through the joing venture. However, whenever this is done, it is one more piece of evidence that indicates the existence of a partnership.

If the joint venture does purchase an asset, the ownership will be shared in the same proportion as the income and expenses are shared. However, if the parties bought the machine jointly, outside the joint venture, any ownership share could exist, depending on each parties financial contribution to the purchase.

4. Accounting

For accounting purposes, a separate accounting system should handle all transactions through the joint account. In addition, each individual should have an accounting system for his personal and business related transactions handled through the individual bank accounts. This creates at least three accounting systems for a two man joint venture. However, there will only be a few transactions in each individual's accounting system. The joint venture's accounting system will have the most transactions.

The accounting system should account for all flows of money between the individuals and the joint venture. Further, the flows of money should differentiate between payments on loans, capital, drawings, etc.

At each year end, it is desirable to pay out any surplus in the joint venture to the individual parties. The following year can then start afresh. If the joint venture requires operating capital, the individual parties could "loan" funds to the joint venture.

5. Income tax

Each party in a joint venture files his own income tax return. A return is not filed for the joint venture. A statement of the income, expenses or net income (whichever applies to the particular joint venture) is prepared for the joint venture. Each party attaches a copy of that statement which indicates his share of the total income, expenses or net income to his personalized income tax return. Further, each party on a separate schedule would calculate income or expenses (eg. interest, car expenses, etc.) paid by himself outside the joint venture and claim capital cost allowance on his individually owned assets.

For taxation purposes, a joint venture is simply an extension of an individuals business activities. It is not a separate business entity as such.

6) Handling Inventory

The inventory (grain, feed, livestock, supplies, etc.) on hand at the beginning of a joint venture or when the relative shares of each party change should be handled in a fair manner. The options for handling inventory are:

a) The inventory on hand at the beginning of the joint venture or when the share ratio changes is sold and shared on the former basis. Expenses for the new period are jointly shared expenses. For example, grain on hand at say January 1 when a joint venture commences, would be sold and be income (including subsequent Canadian Wheat Board Payments) of the party that produced the grain. However, all expenses after January 1, would be shared. This arrangement will likely result in a cash deficit to the joint venture. The parties, however, could lend funds to the joint venture to provide it with operating capital.

b) The inventory is valued at fair market value and each parties share of that value is considered as a loan to the joint venture. The joint venture sells the inventory and repays the "loans" as soon as possible.

7) Husband Wife Joint Ventures

Since 1980, farmers have been able to pay a wage to their spouse and declare the amount as an expense. An alternative to paying a wage to a spouse is to form a husband-wife joint venture for the farm business, therby permitting each party to receive a share of the farm's profits (losses).

As long as one's spouse contributes capital and/or labor, and management then a joint venture can be justified. A joint venture may be more advantageous than paying a wage to a spouse if the spouse's capital contribution is significant. The division of income between husband and wife should be reasonable given their respective contribution of capital and labour to the joint venture.

Capital contributed must in fact belong to the spouse making the contribution. Capital given by one spouse to the other is really capital of the giver.

8) Advantages and Disadvantages of Joint Ventures

Advantages

a) Assets are owned individually and they can be rolled over on a tax deferred basis on a transfer from a parent to a child.

b) Capital assets are pooled which may allow the fixed costs to be spread over a larger base thus lowering costs of production.

c) Labor and management is pooled which permits more specialization and provides individuals with more time off than if the individuals operated sole proprietorship farms.

d) Dissolution of a joint venture is quite simple.

e) Share ratios may be changed easily between years.

Disadvantages

a) As with all types of farm business arrangements, disagreements may arise between the individuals.

b) A joint venture could potentially be interpreted as a partnership with the associated negative income tax and liability implications.

c) Each party does not have the freedom of independence in action and decision making as in a sole proprietorship farm.

9) Dissolution

On dissolution of a joint venture each party would be entitled to his individually owned assets, plus his share of farm inventory, less operating costs.

As in any joint venture, the participants would be well advised to have a written agreement which outlines terms indicated in Section XII, Essentials of a Business Agreement.

IX. Partnerships

1) Definition of Partnership

A partnership is a type of business arrangement where two or more people pool their resources in the form of capital or labor or both, and mutually carry on a profit-motivated business activity. Carrying on business "in partnership" is a well established style of business arrangement. The ways in which profits or losses are shared, capital is to be contributed or withdrawn, and management tasks are performed are completely flexible with a partnership. The formalities required for establishing and operating a corporation are not required for a partnership. This is not to say that formal arrangements should not exist for a partnership. It is advisable to have a written agreement which outlines the business relationship between the partners.

When a business arrangement is being formed, it is important that individuals be aware of the possibility that their business structure is a partnership. There are signficant tax and legal consequences of being a partnership.

The Canadian Income Tax Act makes no attempt to define the term "partnership". Despite that fact, the Act does have some very definite income tax rules applicable to partnerships which will be discussed later. It is therefore necessary to rely on the legal meaning of a partnership in order to determine whether or not one exists in any given situation. In Saskatchewan, the Partnership Act defines a partnership as "the relation that subsists between persons carrying on a business in common with a view of profit".

This definition covers cases where two or more people have expressly agreed to become partners as well as to any arrangement where, in the absence of a written agreement, the conduct of the people would indicate that they are carrying on a business together. Generally, the existence of a partnership can be established by examining the arrangement for the presence or absence of the following features:

a) The individuals are carrying on a business in common. However, if they only share ownership of an income producing property, it is not regarded as carrying on a business (eg. jointly owned apartment block). Also, the simple sharing of gross receipts does not create a partnership.(eg. land rented on a one-third crop share basis).

b) Joint tenancy, tenancy in common, joint property, common property, or part ownership of something such as land does not, in itself, create a partnership even though profits from the land may be shared.

c) The parties involved plan to make a profit from the venture. Where the enterprise is charitable or a public service, the participants are not considered to be partners.

d) All parties are prepared to share any losses which the business might incur. If any one person can only stand to profit and not to lose, then the arrangement is not a partnership.

e) All parties participate in management. This does not mean participation must be equal, since a younger, less experienced partner may contribute less to management and more to labour.

f) Evidence of a partnership may be based on the fact that the parties have contributed capital towards the business and share in its liabilities. However, even if all of them do not contribute capital, a partnership may still exist (eg. where a junior member merely contributes labor).

In summary, every arrangement has to be reviewed on the basis of its own facts so that a judgement can be made as to whether a partnership exists for legal purposes. If a legal partnership does exist, then the various income tax rules concerning partnerships will come into play. However, if a partnership does not exist for legal

purposes, then none of the partnership rules of the Income Tax Act will be applicable.

2) Types of Partnerships

There are two types of partnerships, limited and general. In most farming situations, partnerships would be a general nature. In a general partnership, each of the partners is liable for any debts incurred in the name of the partnership. In the case of a limited partnership, the limited partner is liable for the debts of the partnership only to the extent of his investment. Some of the provisions which govern limited partnerships are:

a) A limited partnership must be registered with the Central Registry in accordance to the provisions of the Partnership Act.

b) The business must include one or more general partners.

c) A limited partner may contribute cash and other capital but not services (including management services). If he takes an active part in management, he may lose his limited liability privileges.

d) A limited partner's name may not appear in the firms name or he may be liable as a general partner to creditors.

e) Subject to the partnership agreement, the limited partner is entitled to share in the partnership profit or other compensation in the form of income.

It is evident that the question of liability is one of the key points regarding the partnership form of business. In a general farm partnership, each partner is liable jointly with the other partners for debts and obligations incurred by the farm while he is a partner. If for some reason the liabilities of a partnership exceed its assets, a creditor or injured party may sue the partnership and each partner for the full satisfaction of his claim. This is an extremely important point to keep in mind when entering a partnership agreement or a business arrangement which could be declared a partnership by a court action.

In addition to the liability aspect, partnerships can be grouped according to how the assets are owned. The main differences are basically the degree of ownership of assets by the partnership versus the partners to the agreement. The following breakdown describes the range of possibilities for a farm partnership:

a) Full partnership
- partnership owns all assets
- individual partners have an interest in the partnership only
- this form of partnership most clearly parallels the concept of an independent entity.

b) Modified partnership
- some assets are owned by the partnership and some assets are owned by individual partners
- individual partners therefore have ownership of certain assets as well as a partnership interest.

c) Operating partnership
- individual partners retain title to all assets used by the partnership
- this type of partnership simply shares labour, income and/or expenses
- a partnership interest would only be created through retained earnings.

d) Husband-wife partnership
- similar in nature to a husband-wife joint venture (see Section on Joint Ventures).

There is a broad range of possibilities for farm partnerships, especially with modified forms. Modified partnerships are the most prevalent type in agriculture and suit many family situations. Full partnerships are not a common occurrence due to the greater advantages of incorporation should an independent entity be desired. Operating partnerships and joint ventures can be nearly identical in structure. Whether one calls it a joint venture or a partnership with regards to division of income does not matter — the key concept is the individual ownership of assets outside the agreement.

3) Tax Considerations

a) Partnership Profits

For Income Tax purposes, a partnership must calculate its net income as if it were a separate entity. However, no income tax is levied on partnership income as it is not required to file a tax return. Instead, the net income (or loss) is allocated to each partner according to the sharing agreement. Each partner must then include his share of partnership income or loss in his own individual tax return. Usually, a financial statement for the partnership's business as a whole is prepared and each partner files a copy of it along with his income tax return. In effect, while net income is determined at the partnership level it is taxed at the individual partner level.

Profits may be shared in any manner agreed upon by the partners. The profit sharing ratio need not be pre-determined nor does it have to be consistent from year to year. Normally, the sharing ratio should be consistent with the amount of capital and labour contributed by each member. Farmers should be aware that Revenue Canada has discretionary powers to reallocate partnership profits.

b) Partnership Interests

An interest in a partnership is "capital property" just as the shares in a corporation are capital property. An interest in a partnership can be bought or sold and a capital gain or capital loss may result. The amount of gain or loss will depend upon each partners adjusted cost base of his partnership interest. The adjusted cost base will be determined by the following:

Adding:

i) the actual cost incurred to acquire or create the partnership interest

ii) the additional capital contributions made to the partnership by the partner

iii) the partner's share of partnership income from his date of admission to the partnership

Deducting:

i) the partner's drawings from the partnership up to the date of calculation

ii) the partner's share of any losses incurred by the partnership from the date he became a partner.

Each partner has his own adjusted cost base of the partnership interest which equals the value of all assets he contributed plus any subsequent investment in the partnership. If a partner draws out more than his share of the income, subject to any agreement, his adjusted cost base will drop by the amount he has overdrawn. Thus, over a period of years, one partner may build up his adjusted cost base through reinvestment of earned income while another may lower his adjusted cost base by drawing more than his share of income.

c) Transfer of Assets to a Partnership

Certain income tax provisions affect the transfer of assets to a partnership. Since the general rule with respect to capital property is that transactions take place at fair market value (FMV), the transfer of property is ordinarily very costly in terms of taxation. However, when setting up a "Canadian partnership", the Income Tax Act allows partners to elect an amount less than fair market value for the transfer price. This "rollover", in effect is a deferral of income tax when property is transferred to a "Canadian partnership". A Canadian partnership, according to the Income Tax Act, is one where all members are Canadian residents at the time of the rollover.

Property for the purpose of this election has a very broad meaning. It includes depreciable property, inventory, accounts receivable and government rights as well as real property. The elected price when property is transferred is considered to be the amount of proceeds received by the partner. This price also becomes the acquisition cost to the partnership. In otherwords, a "deemed disposition" is involved. The underlying rule is that the elected transfer price must not be less than the fair market value of the consideration received; nor can it exceed the fair market value of the property being transferred. In this context, the "consideration received" would not include an interest in the partnership which might be taken back by the partner transferring the property. The following example illustrates the above discussion:

Property to be transferred - land
Fair Market Value of land - $100,000
Adjusted Cost Base of land - $30,000
Fair Market Value of consideration received on transfer = $20,000 (consideration could be cash or a loan)

In this case the elected price could be any amount between $20,000 and $100,000. If a transfer price of $30,000 was elected, neither a capital gain nor a capital loss would occur for the partner. The partner would have a partnership interest of $80,000 in the partnership on account of the transfer of the land plus $20,000 in cash or a receivable from the partnership.

Certain guidelines should be followed when electing a transfer price. Following are a few points to consider:

i) Non-depreciable capital property (eg. land)

- if the elected transfer price is different than the adjusted cost base of the property being transferred a capital gain or loss will result for the partner

- all tax exemptions regarding a principal residence will be disallowed if that residence is owned by the partnership

- the general recommendation is to transfer land into a partnership at its adjusted cost base. Avoid transferring a principal residence into the partnership.

ii) Depreciable capital property (eg. machinery and buildings)

- for assets under the Part XI capital cost allowance method, a value different than the book value (undepreciated capital cost) will result in recaptured capital cost allowance or a terminal loss

- assets still under the Part XVII capital cost allowance method must be included with Part XI assets upon transfer into the partnership

- once depreciable property is owned by the partnership, capital cost allowance is deducted at the partnership level

- the general rule is to transfer Part XI assets at their book value. Avoid transferring Part XVII assets if possible, but if necessary, transfer at their F.M.V.

iii) Inventory (eg. grain, livestock, supplies)

- the rollover provision applies to inventory as well. Since the elected transfer price can be any value between the consideration received and the F.M.V., inventory could be transferred for anywhere from zero to fair market value. Inventory for farmers on the cash basis of accounting is deemed to have a cost of zero.

- electing a transfer price below cost of production reduces taxable income to the partner but will be correspondingly higher to the partnership. Some thought should be given to both the partner's and partnership's tax liability when electing an inventory transfer price.

There is one important factor to consider in the area of capital losses. Should the transfer of capital property result in a capital loss to a majority interest partner (one who controls over 50%), the loss is not recognized, but the ACB of his partnership interest may be increased by the amount of unrecognized capital loss. In the case of a minority interest partner (one who controls less than 50%), capital losses are allowed.

d) Dissolution of a Partnership

We have discussed various tax considerations with respect to transferring property into a partnership. There are also certain tax implications to consider when dissolving a partnership. Normally, transactions between a partnership and its members takes place at the fair market value of the property involved. In the case of a partnership dissolution, where the assets are to be transferred to former partners, another partnership, a corporation or a sole proprietorship, the use of this rule could result in capital gains on property where there is no actual economic exchange or realization. In recognition of this, the Income Tax Act contains provisions where all or part of any gain can be deferred. These provisions allow a taxpayer to reorganize his business structure without a tax burden at the time of transfer. In effect, these provisions allow a rollover of property from one business organization to another with deferral of capital gain for income tax purposes. It is important to remember that the rollover is a postponement of tax, and when the property is eventually disposed of it will be subject to tax. Following are the circumstances under which these special tax rules will apply:

i) Transfer of property to individual partners

When an existing "Canadian partnership" is being totally dissolved, it is possible to rollout partnership assets into individual member's hands without triggering tax. In order to qualify, all of the partnership property must be distributed to all the partners in such a manner that each person has an 'undivided interest' in each of the partnership assets. If the rollover is not used, then a disposition at fair market value is deemed to have occurred giving rise to a potential tax liability.

ii) Changing a partnership into a limited company

In a situation where members of a partnership wish to incorporate their business, there is a provision allowing certain types of partnership property to be transferred with a deferral of any income tax that might otherwise arise.

iii) Changing from one partnership to another

In a situation where one partnership ceases business and a new partnership is formed to carry on, a rollover will be permitted if all of the members of the new partnership were also members of the partnership which had discontinued its business. A common example of this might be in the situation where three people are members of a partnership and one person decides to leave the partnership. Under existing law (subject to any agreement to the contrary) it is considered that the partnership ceases to exist. A new partnership might then be formed between the two remaining partners, to carry on the same business.

iv) Partnership dissolved but one partner continues as a sole proprietor

Where a partnership breaks up and one of the members carries on the former business with property taken from the partnership, a special rollover may also be permitted. Note however, that only one partner is allowed this rollover; the other partner is subject to tax on capital gain. The requirements for this rollover are that it must have been a "Canadian partnership", and within three months of the discontinuance of the partnership the sole proprietor who formerly belonged to the partnership must carry on the partnership business. It is not necessary that all property of the former partnership be used by the sole proprietor in carrying on the business. A common example of this type of rollover may be in a father-son partnership where the father retires and the son continues farming as a sole proprietor. Note that the father could elect to rollover his partnership interest to his son, thereby deferring the tax liability.

The foregoing discussion provides a very general overview of the tax aspects of partnership arrangements. It is impossible to offer a complete review of all legal and tax implications in the publication. It is strongly recommeded that professional counselling be obtained prior to entering a partnership agreement.

4) Advantages and Disadvantages

Advantages

a) *Pooling of financial resources. With the high* capital requirements of modern agriculture, fixed costs can be spread over a larger base, thus lowering total production costs and increasing net returns per unit.

b) Pooling of human resources. A partnership can provide additional labor and management. This allows for some degreee of specialization so that two or more enterprises on a farm are feasible.

c) Income Tax advantages are possible. The rollover provision allows the transfer of assets in and out of a partnership. This includes inventory rollovers, thereby reducing the impact of a high taxable income. Unlike a corporation, both forward averaging and block income averaging are possible for partnership members. Block income averaging is being phased out. The last block income averaging period must include 1987.

d) Through the flexibility of profit-sharing and increasing the partnership interest, a junior partner may build equity in the business and eventually earn an equal or controlling interest in it.

Disadvantages

a) Joint liability of all general partners for any liability incurred, contracts entered into, and injury or damage to others committed by the partnership. This means that each and every general partner may be required to pay the debts and obligations of the partnership if partnership assets are insufficient.

b) Accurate accounting procedures must be used. This includes a year end balance sheet in order to determine each partner's adjusted cost base of his partnership interest.

c) Income Tax advantages are possible. The rollover position allows the transfer of assets in and out of a partnership. This includes inventory rollovers, thereby reducing the impact of a high taxable income. Unlike a corporation, both forward averaging and block income averaging are possible for partnership members. Block income averaging is phased out. The last block income averaging period must include 1987.

d) Potential problems can arise in the partnership on the death or retirement of a partner. These situations can lead to a dissolution of the partnership unless otherwise provided for in the partnership agreement.

X. Corporations

1) What Is A Corporation?

The corporation or "company" is a separate legal entity which exists independent of the shareholders or members who compose it. As a legal entity, a company can do many of the things that a person can do. For example, it may purchase, hold and transfer property, obtain financing and enter into contracts in its own name.

Owners of a company are known as shareholders. Their financial interest in the company is represented by ownership of shares. Once a farmer transfers property to a company, the company takes title to such property. In turn, the farmer has title to the allotted shares which he holds as personal property. The farmer may continue to control the farming business carried on by the company by virtue of his shares in the company, but the company is the legal owner of the farm.

Two types of corporations exist - public (distributing) and private (non-distributing). A farm corporation would normally be a private company in which the right to transfer shares is restricted in some manner. A public company offers its shares for purchase by the public. As a result, the financial affairs of such a company must be open to the public.

A company may be formed in Saskatchewan under the Business Corporations Act. This Act sets out certain regulations governing the use and conduct of a corporation within the province. Anyone wishing to incorporate a business must first register with the Corporations Branch in Regina. A document called the Articles of Incorporation must also be submitted. This is the basic constitution of the company which outlines its name, area of operation, share structure, and any restrictions which it may impose upon itself. Any regulations governing the business or affairs of the company would be set forth in the bylaws. This document would be for internal purposes only and need not be filed with the Corporations Branch.

The share structure which a company adopts can be critical in terms of estate planning and taxation. There are several classes of shares, each offering varying benefits to its holder. Such factors as voting privileges, realization of dividends and equity participation will distinguish one class of shares from another. A company's equity financing is accomplished through the issuance of shares and notes. A note may represent a loan by a shareholder, thus the shareholder becomes a creditor of the company as well.

A detailed discussion of incorporation procedure, company share structures and corporate financing are beyond the scope of this publication. Individuals contemplating incorporation should seek professional advice in this regard.

2) Tax Considerations

The corporation differs from both the sole proprietorship and the partnership in that it pays its own taxes on earned income, whereas in the other two forms of organization, income is taxed in the hands of the partner or proprietor. However, shareholders in a company also pay tax on any dividends or salary received from the company. It is thus important that the overall effects of taxation be considered when comparing corporate versus individual tax implications.

Most Saskatchewan farm corporations (ie. private Canadian controlled) are subject to tax at a fixed rate of 24% on any net income earned through active business. This fixed rate will drop to 22% effective July/1988. Private Canadian controlled corporations which carry on a farming business qualify for a "small business deduction" which in essence is this preferential tax rate. If a corporation is not entitled to this "small business deduction", the applicable rate on taxable income will drop to 42% July 1988. The low tax rate applies to an annual maximum of $200,000 of taxable income.

Salaries are a deductible expense to the corporation, thereby reducing its taxable income. Dividends are not a deductible expense. Since dividends represent "after tax" dollars which then become a part of the individual's taxable income, a dividend tax credit is available to shareholders. The Corporate Distribution Tax will be eliminated effective January 1, 1987.

Corporations are not permitted to use forward averaging or five year block averaging. Thus, any tax savings on income should be related to an individual's average income over an extended time period. It has been suggested that net farm income must be $40,000 or greater annually per individual in order to justify incorporation for the purpose of income tax savings. Further, tax savings, which is really a tax deferral, are only possible if profits are reinvested in the corporation. The withdrawal of profit as dividends, salaries, interest, rent, etc., will largely eliminate the tax deferral. In addition to the taxation of income, consideration should also be given to the tax regulations concerning the transfer of assets into a corporation. As was the case with partnerships, certain rollover provisions are available which allow such transfers without incurring a taxable capital gain. The elected transfer price of farm assets can be less than current market value when transferred to the corporation.

Following are suggested guidelines which should be considered when electing a transfer price:

a) Non-depreciable capital property (eg. land)
- should be transferred at the adjusted cost base in order to avoid capital gain.

- all tax exemptions regarding a principal residence will be disallowed if that residence is owned by the corporation. Avoid transferring a principal residence to the corporation.

b) Depreciable capital property (eg. machinery and buildings)
- assets under the Part XI capital cost allowance method should be transferred at book value (undepreciated capital cost) in order to avoid any recapture of capital cost allowance
- assets under the Part XVII capital cost allowance method will be included with Part XI assets upon transfer to a corporation. These assets should be transferred at their fair market value.

c) Inventory (eg. grain, livestock, farm supplies)
- inventory may be transferred to a corporation for any value between fair market value and cost. For individuals reporting on the cash basis, inventory can be transferred at zero value if desired, thereby deferring all income. The company will pay tax on the inventory when it is sold.

All of the farm assets do not necessarily have to be transferred to the company. For example, a company could merely own the machinery and inventory, while renting the land from the shareholders. Prior to 1978, this was a common way in which farm corporations were designed. Since then, amendments to the Income Tax Act allow shares in a family farm corporation to be transferred to a child of the shareholder without giving rise to any capital gains. This now allows for the same treatment of farmland transfers from one generation to the next under a corporate structure as was available to sole proprietors.

Unlike partnerships, there are no "rollover" provisions for the transfer of assets out of a corporation. Upon dissolution of a corporation, there is a "deemed disposition" of assets at fair market value. Thus, the full value of any capital gains, recaptured capital cost allowance and inventory accruals will give rise to taxation.

3) Advantages and Disadvantages

Advantages

a) Farm Business Continuity

A company has perpetual existence. It will continue as long as the shareholders wish and it meets the requirements of the Business Corporations Act. Provided that managerial responsibilities are shared by two or more

shareholders, many of the problems that develop upon the death of a sole proprietor are avoided.

b) Transferability of Ownership

An incorporated farm lends itself readily to planning the distribution of its assets. The corporate form of organization converts ownership of specific assets into more readily transferable preferred and/or common shares which represent the ownership of the business as a whole. For estate planning purposes, it is much easier to implement an orderly transfer of shares from principle shareholders to children during their lifetime and after their death.

c) Credit Availability

The pooling of land, capital and equipment under one entity may create a stronger, more efficient operation which is able to obtain a larger amount of credit than a sole proprietorship. With assured continuity of the business from one generation to the next, lenders may be more inclined to extend longer term credit as well.

d) Tax Savings

A Canadian-controlled private corporation is taxed at a fixed rate of 22% on the first $200,000 of taxable income each year effective July 1, 1988. In situations where annual taxable income exceed $40,000 per individual, tax savings can occur. In addition, some degree of "income splitting" can be achieved through payment of wages to a spouse, although this can be accomplished by sole proprietorships and partnerships, too.

The liability of a shareholder is limited to the value of his shares in the company. Investments outside the company are not required to be used to settle company liabilities. This advantage is lost if lenders require personal guarantees. Also, an individual's liability for public injuries, property damage and sale of defective products can be limited through the purchase of insurance.

Disadvantages

a) High Cost of Incorporation

There are significant start-up costs and annual operating costs related to incorporation. Legal fees will vary depending on the complexity of the business and the amount of property being transferred. In addition, opening and annual financial statements must be prepared, along with a more complex income tax return. The services of an accountant are normally required, which could result in a high annual cost.

b) High Cost of Dissolution

Because there are no rollover provisions when transferring assets out of a corporation the tax costs may be very high when dissolution occurs. Also, legal and accounting fees may be higher than for a proprietorship.

c) Income Tax Disadvantages

A corporation loses both forward averaging and five year block averaging privileges. This is mainly a drawback with enterprises subject to wide fluctuations in income (eg. grain). If the principal residence is transferred to the corporation the entire capital gain will be taxable when it is ultimately sold. A pre - 1972 basic herd cannot be rolled into a corporation as the concept of a basic herd is being phased out. Breeding stock are treated as inventory and not capital.

d) Extra Administration

More administration of a corporate farm business is required. It involves more work with lawyers and accountants. Some farmers express concerns about loss of control in a corporate structure and the need to rely on consultants for advice.

Revenue Canada levies severe penalties when corporate funds are used for personal use. Accurate and careful accounting of the withdrawal of funds from a corporation is essential.

Since the tax, legal and estate planning implications will vary with each situation, it is suggested that farm families discuss their situation with lawyers and accountants who have experience with farm incorporation. Further information is contained in the publication "Farm Incorporation", which is available from Saskatchewan Agriculture.

XI. Co-operatives

1) Machinery Co-operatives

Under the section headed "Machinery Sharing", a brief discussion was given to single-purpose machinery co-ops. This is the type of co-op in which specialized equipment is mutally purchased in order to reduce the capital cost to individual members. A multi-purpose machinery co-op is one in which the equipment purchased is oriented towards farm production. The pooling principle for distribution of income and expenses is critical to the satisfactory operation of these co-operatives.

It is used in order to combine resources and divide operating costs and revenues on a fair and equitable basis. Member participation is calculated through a common denominator such as cultivated acres. For instance, if a member contributes 800 cultivated acres to the co-op's total of 4,000 acres, his share is 20%. He therefore provides 20% of the fixed capital, 20% of operating costs and receives 20% of all sale proceeds. If there is much difference in the productivity of members' land, the basis for distribution of income can be adjusted accordingly.

Initial contributions of fixed capital may be in the form of presently owned equipment or cash. A method of evaluating machinery contributions must be established. If a member's machinery contribution has a valuation which is more than his share of the total capital required, he should receive a cash payment in return. If the value is less, he must make an additional payment to the co-operative. Outside financing can be obtained through conventional credit sources.

The basic concept behind a machinery co-op is that the co-op owns and controls the use of machinery and equipment. The individual assigns his land for production purposes to the co-operative. The co-op manages all field operations and co-ordinates labor inputs by its members. However, each member retains his farmer status and therefore is entitled to a permit book. He will deliver his share of the grain and from this income will pay his share of operating expenses and machinery financing. Each member is also responsible for his own land cost including taxes.

In these respects, a machinery co-op closely parallels a modified partnership. Some of the assets are owned by the members while others are owned by the co-op. Income is determined at the co-op level, but is then distributed and subsequently taxed in the hands of the members.

2) Co-operative Farms

A co-op farm differs from a machinery co-op in that the co-op acquires total control of the land base. This may either be through purchasing or leasing the members' land holdings and/or leasing outside land. In many respects, a co-operative farm resembles a corporation. For instance, a co-op must be registered, a Memorandum of Association and set of bylaws must be prepared, an annual report must be submitted, ownership is through shares, and the shareholder's liability is limited to the value of those shares.

The main feature which distinguishes a co-op from a corporation is the method of control. Regardless of how many shares or how much capital a member has invested, he only has one vote. This means that each member of the co-op has an equal say in the operation of the business, whereas in a company the distribution and type of shares determines who has control.

Revenue Canada treats a co-op entity similar to a corporate entity with respect to taxation. If the co-op qualifies for the small business deduction, it will be taxed at the special low rate of 22% on the first $200,000 of active business income effective July 1, 1988. However, the co-op computes its taxable income after patronage dividends are distributed to shareholders whereas the corporation computes its taxable income before dividends are distributed. By distributing all its income as patronage dividends, a co-op could conceivably end up with no taxable income at all.

Property can be rolled into a co-op in the same manner as into a corporation and co-op shares can be rolled over to children at their adjusted cost base, thus avoiding capital gain. However, the same tax disadvantages which apply to corporations also apply to co-ops. All tax exemptions regarding a principal residence will be disallowed if that residence is owned by the co-op. Neither forward averaging nor five year block averaging are permitted. The main disadvantage is that at discussion property transfers occur at fair market value giving rise to taxable capital gains, recaptured capital cost allowance and taxation of accrued inventories.

Any two or more individuals can form a co-operative farm. Personnel from the Department of Co-operative Development are available to assist with the necessary documentation. However, it is important to obtain the services of an accountant who can advise on the transfer of assets into the co-op. Accounting services may also be required for the preparation of annual financial statements.

The question of whether to form a co-operative rather than a corporation rests largely on personal ideals. The participants must be highly compatible and dedicated to the co-operative principles. The establishment of a co-operative venture does not necessarily result in a successful and viable operation. Most failures can probably be attributed to the fact that the members were found to be incompatible and as a result, disagreements occurred. It is thus very important to have an equitable dissolution clause included with the by-laws.

Further information on the establishment and operation of a farm co-op or machinery co-op may be obtained from the Saskatchewan Department of Co-operation and Co-operative Development.

XII. Requirements of a Successful Business Arrangement

There are a large number of business arrangements used by farm families today. There are countless variations to each basic type. This is because families have different objectives, different resources and different relative contributions. Many social and economic principles must exist in order to achieve a successful business arrangement. Failure to observe these principles may result in a short-lived, disappointing experience which often leaves bitter memories. Following are some of the main principles to consider:

a) Potential for Sufficient Income

The business must generate sufficient income to support all parties. None of the business organizations discussed will succeed if the income base is insufficient to support more than one family. Remember that income from a given farm situation can not be increased simply by reorganizing the farm under a different business arrangement.

b) Equitable Sharing of Income

Income must be divided on a business-like basis. The most accepted principle of sharing is on the basis of each party's contribution. Another way in which income could be divided is to agree on an acceptable return which will be paid for labour and capital. Any surplus income would be split on some equitable basis. This is the common arrangement under a corporate structure. Whichever arrangement is used, it must be fair to all parties, otherwise dissension will occur and success of the arrangement is jeopardized.

c) Ability to Work Together

The parties involved must be able to get along. A certain amount of "give and take" is essential. Individuals who have difficulty getting along beforehand will probably find their differences intensified in a business arrangement.

d) Good Communication

Good communications between all parties involved is important. Individuals need to discuss their thoughts and concerns about the business openly and completly. Dissatisfactions which are bottled up will eventually explode and possibly destroy the business arrangement.

Many successful arrangements conduct regular business meetings such as once a month, week or even a short meeting each day. Occasionally it is useful to hold a meeting at a place other than the farm.

e) Shared Management

Demands on management are greater for most business arrangements than for a sole proprietorship. This is because the business organization is more complex and decisions often have to be made jointly. It is advisable that major decision making be shared. This means a mutual regard for the other person's opinion. In this manner, all parties are fully aware of business affairs and it may stimulate better ideas for improving the business.

Sharing management can be a problem where one party (eg. son) joins another party (eg. father) in an established farm business. If the existing party (father) has operated as a sole proprietorship he has been making decisions on his own. The father often has difficulty in relinquishing some decision making responsibilities and accepting the opinion of his son. The party entering the business (son) is eager to make decisions in the business. A resolution of this possible conflict is essential to a successful operation.

f) Adequate Records

In order to monitor capital contributions and equitably distribute earned income, accurate records must be maintained. This may involve the use of a bookkeeping agency or obtaining the services of an accountant.

g) Satisfactory Living Arrangements

Individual circumstances will determine the kinds of living arrangements required. Most business arrangements fail because of personal conflicts. Generally, it is best if each party's personal life be kept out of the business as much as possible. This requires separate housing and preferably separate yards for each family.

h) Written Agreement

The business arrangement should be in a written agreement so that each party knows what is expected. This also assists in avoiding and solving any disputes which might arise in the future. The exercise of sitting down and working through the terms of an agreement, forces the parties to understand and appreciate the arrangement better. The agreement should also provide some flexibility to the arrangement. People's requirements as well as economic and social conditions change over time. Provisions in the written agreement to allow for modifications are necessary.

i) Long Range Planning

At the outset, parties to a business arrangement should define their long term goals. The goals of the individuals as well as the goal or purpose of the business organization should be considered. Is the purpose of the arrangement simply to facilitate

an estate plan, or is it an avenue towards developing a strong, unified business organization? What are the retirement needs of older members? Will certain assets be ultimately shared with other family members who are not actively involved in the operation? Such factors need to be considered before choosing a particular type of arrangement.

Often when two or more parties begin a new business arrangement, it is best to operate under a flexible arrangement which is not irreversible (eg. Land titles transfered, corporations, etc.) for two or three years. This gives the parties a chance to determine if they will be able to work together for a longer period. After this period, a more permanent arrangement might be considered.

XIII. Essentials of a Business Agreement

One of the important requirements of a business arrangement is the need for a written agreement. Except for corporations and co-operatives, where formal documentation always exists, it is up to the individuals to mutually prepare a written agreement. The main purpose of the agreement is to set out as clearly as possible the exact nature of the business relationship between the parties involved. As a minimum, the agreement should cover the following points:

a) the full identity of each individual involved in the business arrangement

b) if business will be conducted under some legal name, this should be indicated (eg. Smith Bros. Machinery Syndicate)

c) the purpose for which the business arrangement has been formed

d) the contributions of capital which are being made to the business arrangement by each member

e) the way in which income and/or expenses are to be divided among the members, including provisions for cash withdrawals if applicable

f) the income and expenses which will be excluded and paid individually

g) the method to be used to handle beginning inventories

h) procedure for handling debts and debt payments

i) the method of accounting which is to be used to monitor income and/or expenses

j) the formula for dividing and pricing inputs where costs are being shared. This must allow enough flexibility to reflect changes in cost

k) the rights and duties of each member. This includes his responsibilities to the arrangement and his exact role in the management of the business

l) the method to be used for solving disagreements among members

m) the conditions under which a dissolution of the business arrangement will be considered to occur as well as those circumstances which will not dissolve the arrangement

n) the method of distributing assets at dissolution or the agreement as a result of death, retirement of mutual agreement.

These are the basic points which should be included in the agreement. Since each situation will vary according to the type of arrangement and member needs, other matters may have to be dealt with as well. It is suggested that the agreement be formalized by a lawyer. He can be helpful in advising on points to cover, and ensure that the agreement is perfectly clear and binding from a legal standpoint.

XIV. Other Publications on Farm Business Arrangements

Saskatchewan Agriculture "Land Rental Arrangements" Farm Management Section

Saskatchewan Agriculture "Crop Share Lease Agreement" Farm Management Section

Saskatchewan Agriculture "Cash Lease Agreement" Farm Management Section

Saskatchewan Agriculture "Flexible Cash Lease Agreement" Farm Management Section

Saskatchewan Agriculture "Supplementary Forms for Land Lease Agreements" Farm Management Section

Saskatchewan Agriculture "Income Tax Management for Farmers" Farm Management Section

Saskatchewan Agriculture "Estate Planning for Farm Families" Farm Management Section

Saskatchewan Agriculture "Farm Incorporation" Farm Management Section

Saskatchewan Agriculture "Leasing Farm Machinery" Farm Management Section

Saskatchewan Agriculture "Law for Saskatchewan Farm Families" Farm Management Section

Saskatchewan Agriculture Employment Development Committee "Farm Employee Management"

Department of Co-operation & Co-operative Development "Machinery Co-operative Model"

XV. Information and Services Available to Farmers

1) Saskatchewan Department of Agriculture

- Provides free bulletins and counselling to the public on farm business arrangements, income tax, estate planning and other related areas. Bulletins are available from Ag. Rep. offices, and other Saskatchewan Department of Agriculture offices.
- Offers courses on farm business arrangements in local farm communities.

Farm Management Section
Room 329, Walter Scott building
REGINA, Saskatchewan S4S 0B1
Phone: 787-5942

Regional Farm Management Specialist:
a) 105 Provincial Office Building
NORTH BATTLEFORD, Saskatchewan S9A 3G7
Phone: 445-6146

b) Box 640
ROSETOWN, Saskatchewan S0L 2V0
Phone: 882-4229

c) 350 Cheadle Street West
SWIFT CURRENT, Saskatchewan S9H 4G3
Phone: 773-2866

d) 110 Souris Avenue
WEYBURN, Saskatchewan S4H 2Z9
Phone: 842-4607

e) Provincial Building
YORKTON, Saskatchewan S3N 2Y4
Phone: 783-9743

f) Box 1480
99th Street
TISDALE, Saskatchewan S0E 1T0
Phone: 873-2693

2) Revenue Canada

- Provides free booklets and information circulars on many income tax topics which relate to farm business arrangements. Common publications include the "Farmer's Income Tax Guide" and "Income Tax Guide" which are sent to farmers each year. Other booklets are available at the district taxation office.
- Information available from district taxation offices
- Appeal Procedures:
i) Notice of Objection (Form T40 0A) must be filed within 90 days from mailing of the Notice of Assessment if the taxpayer disagrees with the Notice of Assessment or Reassessment.
ii) Tax Review Board - A taxpayer may appeal to this Board if the objection is not allowed.
iii) Federal Court of Canada - This is the last appeal procedure if the Tax Review Board rules against the taxpayer.
iv) Advance Rulings - These can be obtained for a fee. The rulings may be advantageous to a taxpayer when considering an unusual business transaction with major tax implications.

District Taxation Offices:
a) Income Tax Building
1955 Smith Street
REGINA, Saskatchewan S4P 2N9
Phone: 780-6015

b) Canadian Imperial Bank of Commerce Building
201 - 21st Street East
SASKATOON, Saskatchewan S7K 0A8
Phone: 665-4595

**General Information — Toll Free Number — 1-800-552-8031

3) CCH Canadian Limited

— Sells books and pamphlets on various income tax topics and issues an annual guide to filing income tax returns.
— Free publication list is available
CCH Canadian Limited
6 Garamond Court
DON MILLS, Ontario M3C 1Z5
Phone (416) 427-2992

4) Other Information Available to Individual Farmers

a) Local Chartered Accountants and General Accountants
- Income Tax Filing, and individual counselling on all tax related matters.

b) Lawyers
- advice on legal aspects.